OGC 81-10280

3 December 1981

MEMORANDUM FOR: Stanley Sporkin
General Counsel

FROM:

Office of General Counsel

SUBJECT: Weaknesses in the United States Defense Industrial Base

To maintain national self-determination, a nation must control sufficient means of production to provide a strong national defense. A nation which lacks access to means of defense production will not survive; a nation which has access only to means of defense production controlled by other nations may survive, but it will not retain its independence. Although the United States has enjoyed for the past century a domestic industrial base sufficient to support a strong national defense, the past decade has witnessed deterioration of the U.S. defense industrial base, 1/ increasing dependence on foreign inputs into U.S. defense production, and increased foreign investment in U.S. industry. Although these trends have not yet produced a clear, direct threat to the national defense of the United States, left unchecked they will do so.

A critical lack of capital investment, shortages of skilled labor, and instability in defense procurement programs have contributed to shrinkage of the defense industrial base. The decrease in the number of firms able, and willing, to engage in defense production has increased the cost of defense procurement, 2/ increased the length of time required to produce and deliver a finished

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1/ The "defense industrial base" encompasses those elements of the economy with the capacity to produce goods or provide technical expertise in support of national defense activities. The Ailing Defense Industrial Base: Unready for Crisis, Rept. No. 29, Defense Industrial Base Panel of the Committee on Armed Services, House of Representatives, 96th Cong., 2d sess., 5 (31 December 1980) ("HASC Report").

2/ A reduction in the number of firms competing for defense contracts reduces the incentive for the remaining firms to hold down costs to keep the government from giving its business to competitors.

defense product, 3/ and has forced the government in some cases to rely on foreign sources for defense item components.4/

While the U.S. economy generally has suffered from depressed capital investment, the drop in rates of capital investment in the defense industrial sectors of the economy has been particularly pronounced. High interest rates, high inflation, tax disincentives, cash flow problems, and a relatively low return on investment have discouraged firms from investing in new capital equipment to support defense production. In addition to reducing funds available for new capital equipment for defense production, many firms have converted their existing capital equipment from defense production to more lucrative and reliable commercial business.5/

In addition to capital investment constraints on production capacity and productivity, the defense industrial base suffers from the severe shortage in the U.S. economy of skilled manpower, particularly in the engineering and computer science professions, and in the skilled machinist trades.6/ The escalating cost of training highly skilled employees, the relatively modest profits associated with defense production, and the discontinuity plaguing defense procurement programs have combined to reduce the ability of defense contractors, particularly at the subcontractor level, to train in-house the highly skilled manpower they cannot obtain on the open labor market.7/

Instability in defense procurement programs compounds the problems of inadequate capital investment and insufficient skilled manpower. Restrictions on advance procurement, multi-year contracting, and funding of defense contracts discourage firms

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3/ Serious bottlenecks in defense production resulting from decreased production capacity, particularly at the subcontractor level, have resulted in dramatic increases in lead times since 1978. HASC Report, 13.

4/ Report of the Defense Science Board Task Force on Industrial Responsiveness, Office of the Under Secretary of Defense for Research and Engineering, 11 (January 1981) ("DSB Report").

5/ Memorandum of Deputy Secretary of Defense Frank C. Carlucci, "Improving the Acquisition Process," Recommendations, 5 (30 April 1981) ("DEPSECDEF Memorandum").

6/ HASC Report, 15.

7/ Statement of Hans Weiss, President, Dynamic Metal Products, Hearing on Deterioration of the U.S. Defense Industrial Base, Committee on Small Business, United States Senate, 97th Cong., 1st sess., 204 (14 July 1981) ("SSBC Hearings"). <u>See</u> DSB Report, 9.

from capital formation, afflict skilled manpower with job insecurity, and increase procurement costs due to inefficient production runs.8/ Fundamental changes in procurement decisions on major defense acquisition programs accompanying changes in Administrations have exacerbated the instability in the defense acquisition process.

In addition to problems in maintaining a strong defense industrial base, the nation has had difficulty assuring a stable, reliable supply of certain inputs into the base. The United States currently depends upon foreign sources for half its supply of twenty of the forty minerals most critical to the U.S. economy.9/ The reliance of the U.S. defense industrial base on foreign mineral supplies is particularly acute since Department of Defense procurement items depend heavily on specialty metals and alloys for which the raw material inputs lie outside the United States.10/ Since 1946, the nation has maintained a National Defense Stockpile of critical materials for defense production use in the event of an interruption of foreign mineral supplies.11/ Many of the materials on hand in the Stockpile are no longer of sufficient quality to support defense production, due to deterioration of the materials and technological advances which require higher quality materials. Stockpile inventories for many of the materials are well below assigned goals.12/

The problems associated with a deteriorating defense industrial base and increasing dependence on foreign sources of strategic commodities have been compounded by a dramatic increase in the past seven years of foreign investment in the United States. The magnitude of foreign investment raises concern that

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8/ HASC Report, 13. See Department of Defense Statement on Industrial Readiness, Before the Defense Industrial Base Panel, Committee on Armed Services, House of Representative, 96th Cong., 2nd sess., (3 December 1980).

9/ HASC Report, 25.

10/ DSB Report, 60. For example, the U.S.S.R. and a handful of nations in southern Africa contain 99 percent of the world's manganese ore, 97 percent of the world's vanadium, 96 percent of the world's chrome, 87 percent of the world's diamonds, and 65 percent of the world's cobalt, all of which are essential to defense production. HASC Report, 25.

11/ The Federal Emergency Management Agency manages the stockpiling program under National Security Council guidance in accordance with the Strategic and Critical Materials Stock Piling Act of 1946, 50 U.S.C. 98 et seq., the Defense Production Act of 1950, 50 U.S.C. App. 2061 et seq., and the Federal Civil Defense Act of 1950, 50 U.S.C. App. 2251 et seq.

12/ DSB Report, 62.

foreign countries, foreign business enterprises, and foreign citizens will gain the power to affect directly and materially those sectors of the United States economy upon which the national security depends. United States law on foreign investment in the U.S. consists of statutes which give the President extraordinary economic powers in emergencies, statutes which restrict foreign investment in certain economic activities, and statutes and Executive Orders providing for limited monitoring of certain types of investments. However, these statutes and Executive Orders do not provide the federal government with a regular, comprehensive mechanism through which to determine whether existing and potential foreign investments in the United States are consistent with the national security and to prohibit those which are not.

To solve the problems of a deteriorating defense industrial base, increasing dependence on foreign sources of strategic materials, and increasing foreign control of U.S. industrial enterprises, the United States can utilize existing statutory authorities more effectively, enact new authorities where existing ones are insufficient, and adjust the defense procurement system. As with most solutions to national problems, elements of the solution to the defense industrial base problem will cost money, either through increased appropriations or foregone revenue. To some extent this cost may be recovered over time through cost reductions attributable to increased defense production efficiencies. Attached are ideas for action which could contribute to revitalizing the defense industrial base.

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Attachments

POTENTIAL SOLUTIONS FOR PROBLEMS OF DETERIORATING DEFENSE INDUSTRIAL BASE, DEPENDENCE ON FOREIGN INDUSTRIAL INPUTS, AND FOREIGN CONTROL OF INDUSTRIAL ENTERPRISES

I. GOVERNMENTAL ASSISTANCE TO FAILING DEFENSE PRODUCTION FIRMS

II. EFFORTS TO INCREASE CAPITAL INVESTMENT IN DEFENSE INDUSTRIAL BASE

III. EFFORTS TO INCREASE SUPPLY OF HIGHLY SKILLED MANPOWER FOR DEFENSE INDUSTRIAL BASE

IV. EFFORTS TO REDUCE DEPENDENCE ON FOREIGN SUPPLIES OF RAW MATERIALS

V. REVIEW OF FOREIGN INVESTMENT IN THE UNITED STATES FOR CONSISTENCY WITH NATIONAL SECURITY

I. GOVERNMENTAL ASSISTANCE TO FAILING DEFENSE PRODUCTION FIRMS

Loan Guarantees and Direct Loans.

To firms in the defense industrial base with insufficient cash flow to meet their needs, whose production capacity is important to the national security, the United States could lend its credit by guaranteeing repayment of commercial loans which lending institutions make to the firms. For firms whose position is so dire that federal loan guarantees will not suffice, the United States could make direct loans to the firms. Both loans and loan guarantees for these purposes are authorized under the Defense Production Act of 1950, 50 U.S.C. App. 2091, 2092.

Inventory Purchase with Repurchase Right.

For firms whose production capacity is important to the national security, who also engage in commercial production, but who suffer cash flow problems, the United States could purchase their commercial inventories and give the firms option to repurchase the inventories at the same price when commercial demand for the items improve.

Direct Contract Awards to Maintain Capacity.

Notwithstanding requirements for competitive bidding in federal procurement, defense acquisition contracts could be awarded directly to firms whose production capacity is important to national security, who might otherwise go out of business.

Tax Incentives to Purchase from Failing Companies.

The Internal Revenue Code could be amended to provide special tax credits to purchasers of goods from firms important to defense production who might go out of business without the demand the tax incentives would create.

II. EFFORTS TO INCREASE CAPITAL INVESTMENT IN DEFENSE INDUSTRIAL BASE

Accelerated Depreciation of Capital Equipment for Defense Production.

Depreciation of an asset is based on its acquisition cost rather than its replacement cost at the end of its useful life. In an era of consistently high rates of inflation, replacement cost will far exceed the original acquisition cost. By amending the Internal Revenue Code to allow defense production firms to accelerate depreciation of their capital equipment, i.e. shortening "useful lives" of such assets for tax purposes, the acquisition cost can be recovered and replacement or additional equipment purchased before replacement costs far exceed the amount of acquisition cost recovered through depreciation. An alternative tax incentive would be to permit depreciation of capital assets over existing "useful lives," but based on replacement cost rather than acquisition cost, using a rolling five year average of inflation rates to predict replacement costs.

Tax Credits for Purchase of Capital Equipment for Defense Production.

Amending the Internal Revenue Code to provide special tax credits for investment in capital equipment to support defense production would provide defense contractors with a powerful incentive for capital investment.

Increased Funding for Defense Manpower Technology Program.

Under the DOD Manufacturing Technology (MANTECH) program, DOD provides research and development funds for technological innovations in capital equipment which firms may have the benefit of provided they fund the application in full scale production. The 1980 Defense Science Board Task Force on Industrial Responsiveness estimated the DOD's return through cost savings on MANTECH investment to be about 5 to 1. By relieving defense production firms of research and development costs associated with modernization of capital equipment, increased funding for the MANTECH program would help industry to improve the size and productivity of the defense industrial base.

Multiyear Defense Procurement Contracting.

For the most part DOD makes contracts for procurement other than shipbuilding on a year-to-year basis. Multiyear contracting for defense procurement would permit the government to offer long-term production contracts to firms, giving them greater incentives to make capital investments in support of their defense contracts, and improving productivity through economies of scale, a stable work force, and reduced administrative costs. Existing restrictions on multiyear contracting should be eased.

The funds appropriated under the Procurement title of the Department of Defense annual appropriation act are not restricted to obligation in the year for which they are appropriated, thus permitting multiyear contracting. However, a statutory limitation of contract cancellation payments to $5,000,000 without express Congressional approval effectively restricts multiyear contracting to a few low value contracts. The statutory limitation on cancellation payments will be raised to $100,000,000 upon final enactment of S. 815, the DOD FY 1982 Authorization Act, permitting more effective multiyear contracting.

The funds appropriated under the Operations and Maintenance title of the annual DOD appropriation act are restricted to obligation in the year appropriated, unless otherwise provided by law. Congress has authorized DOD to use these single year appropriations for multiyear contracting outside the United States, 10 U.S.C. 2306(g), in certain circumstances. DOD will be permitted to exercise similar authority within the United States in the same circumstances for effective multiyear contracting, upon final enactment of S. 815, the DOD FY 1982 Authorization Act.

The "full funding" policy Congress follows in providing annual procurement appropriations also limits the effectiveness of multiyear contracting. Under the full funding policy, each annual appropriation request must contain the funds estimated to be required to cover the total cost to be incurred in completing the delivery of a given quantity of usable end items. For stable programs suitable for multiyear contracting, this full funding policy creates inefficiencies since it effectively prohibits funding material, parts, and subassembly work in the current year for incorporation into end items to be produced in subsequent years. Programs suitable for multiyear contracting should not be subjected to the full funding policy, which reduces the benefits of multiyear contracting.

Direct Government Investment in Capital Equipment for Defense Production.

The Department of Defense can use its existing authority under the Defense Industrial Reserve Act, 50 U.S.C. 451 et seq., to purchase production facilities which it will operate (GOGO - government owned, government operated) or which it will hire private contractors to operate (GOCO - government owned, contractor operated). Although such facilities are expensive and may result at times in substantial idle capacity, they have the advantage of always being available and within complete control of the government when needed.

The Department of Defense can also use its existing authority under the Defense Industrial Reserve Act to add to and to replace aging government-owned machine tools placed with private firms in accordance with 50 U.S.C. App. 2093(e) and also those DOD holds in emergency plant equipment packages.

III. EFFORTS TO INCREASE SUPPLY OF HIGHLY SKILLED MANPOWER FOR DEFENSE INDUSTRIAL BASE

Tax Incentives for Defense Production Firm Training Programs.

The Internal Revenue Code could be amended to provide a special tax credit to firms engaged in defense production which establish in-house training programs for engineering and computer science professionals and skilled machine tradesmen.

Grants to Vocational Institutions.

Federal grants to vocational institutions which train students in the highly skilled machinist trades in amounts directly proportional to the number of skilled machinists they produce would increase the supply of skilled machinists for the defense industrial base.

Direct Student Grants.

Extension of federal programs for direct student grants to persons who pursue engineering and computer science degrees would increase the supply of engineers and computer scientists for the defense industrial base. Recipients of grants who either fail to complete degree requirements or who fail to work as engineers or computer scientists for a certain number of years after graduation would be required to repay the grant.

IV. EFFORTS TO REDUCE DEPENDENCE ON FOREIGN SUPPLIES OF RAW MATERIALS

Exploitation of Mineral Resources on Federal Public Lands.

The 750 million acres of public land in the United States contain huge mineral resources which could be exploited to reduce U.S. dependence on foreign sources of many materials.

Reduce Federal Regulatory Disincentives to Mining Exploration and New Production.

Restrictions on mining exploration and new production imposed by the Clean Air Act, Federal Water Pollution Control Act, Wilderness Act, Federal Land Policy and Management Act, and the Surface Mining Control and Reclamation Act which discourage firms from finding and exploiting domestic mineral resources could be modified to encourage such activities.

Provide Federal Incentives to Expand Domestic Mining Production.

The federal government could offer loan guarantees, loans, purchase commitments, guaranteed production levels, and guaranteed prices to encourage private industry to explore for and exploit domestic mineral sources. The Internal Revenue Code could be amended to provide additional tax credits for such exploration and exploitation.

Improve the National Defense Stockpile.

Strategic and critical materials stocks could be increased to meet the statutory goal of ensuring a three year supply on hand of these materials. In addition, materials in the stockpile which are no longer of the quality required for defense production could be reprocessed or rotated out of the stockpile.

V. REVIEW OF FOREIGN INVESTMENT IN THE UNITED STATES FOR CONSISTENCY WITH NATIONAL SECURITY

Foreign Investment Review Legislation.

To protect against foreign control of United States industrial enterprises important to the national security, legislation could be enacted to grant to the President broad authority to screen out foreign investments in the United States which would be inconsistent with national security. An example of legislation which would establish a comprehensive foreign investment review mechanism is attached.

The draft legislation would require potential foreign investors to give notice to the President of plans to acquire an ownership interest in a U.S. firm and to wait forty-five days to permit the President to review the proposed investment. The President could disapprove the investment or impose conditions upon it if the national security so requires. The legislation also grants to the President authority to review investments that have been made, and to require divestiture or impose conditions upon continued holding of the investment if the national security so requires.

The legislation gives the President great administrative flexibility in executing the policy of assuring that foreign investment is consistent with U.S. national security. The President would have authority to define the terms used in the Act, to prescribe regulations to implement the Act, and to exempt investments from the requirements of the Act. Also, the President could delegate any or all of the functions assigned to him by the legislation to any officer appointed by the President with the advice and consent of the Senate. 3 U.S.C. 301.

H.R. _____/S. _____

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as the "Foreign Investment National Security Review Act of 1981".

SEC. 2. It is the policy of the United States to permit the free flow of capital into the United States only insofar as it is not detrimental to the national security of the United States.

SEC. 3. No foreign person shall--

(a) acquire, directly or indirectly, any ownership interest in any United States firm, unless the foreign person files the notification required under subsection 4(b) and the waiting period described in Section 5 has expired without the President having disapproved the acquisition as detrimental to the national security of the United States, or

(b) hold, directly or indirectly, any ownership interest in any United States firm, whether acquired prior to or subsequent to enactment of this Act, if the President has disapproved continued holding of the interest as detrimental to the national security of the United States.

SEC. 4. The President, consistent with the policy of this Act--

(a) may--

(i) define the terms used in this Act,

(ii) exempt from the requirements of this Act acquisitions and holdings which are not likely to be detrimental to the national security interests of the United States, and

(iii) prescribe such regulations as may be appropriate to carry out the provisions of this Act;

(b) shall require that the notification under subsection 3(a) be in such form and contain such documentary material and information as is appropriate to enable the President to determine whether the acquisition would be detrimental to the national security of the United States;

(c) shall impose such continuing reporting requirements on foreign persons holding ownership interests in United States firms as are appropriate to enable the President to determine whether continued holding of an interest by a foreign person would be detrimental to the national security of the United States; and

(d) shall disapprove acquisition or continued holding by a foreign person of an ownership interest in a United States firm if such acquisition would be detrimental to the national security of the United States, provided that the President may in lieu of disapproval impose such conditions on acquisitions or continued holdings as may be consistent with national security.

SEC. 5. The waiting period required under subsection 3(a) shall begin on the date the completed notification is received, and end on the forty-fifth day after such receipt, unless the President extends the period in the interests of the national security of the United States.

SEC. 6.(a). The United States may enforce this act through civil proceedings in an appropriate district court of the United States, which shall grant the United States such monetary, injunctive, and declaratory relief as may be appropriate.

(b) Any person who fails to comply with any provision of this Act, or any regulation prescribed to carry out this Act, shall be--

(i) liable to the United States for a civil penalty of not more than $20,000 for each day during which such person is in violation of this Act or an implementing regulation; and

(ii) subject to injunction to compel compliance with this Act, including orders enjoining such person to divest himself of ownership interests in United States firms.

This subsection shall not be construed to limit the authority of a district court to provide other appropriate relief as provided for in subsection (a) of this section.

SEC. 7. Any information or documentary material filed pursuant to this Act shall be exempt from search, review, and disclosure under Section 552 of Title 5, United States Code.